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RR RUEHDBU RUEHLN RUEHVK RUEHYG  
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R 301200Z JAN 07  
FM AMEMBASSY ASTANA  
TO RUEHC/SECSTATE WASHDC 8338  
INFO RUCNCIS/CIS COLLECTIVE 0021  
RUEHAST/USOFFICE ALMATY  
RUEHBJ/AMEMBASSY BEIJING 1295

UNCLAS SECTION 01 OF 04 ASTANA 000277

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FROM CHARGE D'AFFAIRES TO EB ASSISTANT SECRETARY SULLIVAN

E.O. 12958: N/A

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SUBJECT: SCENESETTER FOR ASSISTANT SECRETARY SULLIVAN'S VISIT TO KAZAKHSTAN

Ref: Astana 125

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1. (SBU) Summary: While recent Kazakhstani headlines have been dominated by discussion of the country's new government, its bid to assume the OSCE chairmanship, and a democratization initiative presumed to be in the works, the real, abiding story here is Kazakhstan's economy. The country's natural resource wealth is well-known and, by and large, well-managed; much of the USG's attention in this arena is focused on the development of pipeline routes to carry oil and gas out of landlocked Kazakhstan. While far from being Kazakhstan's top trading partner, the U.S. is the largest foreign investor. The company executives you meet here will tell you about an investment climate that is, at times, challenging, while simultaneously discussing expansion plans - or, in private, bids for new oil blocks.

2. (SBU) Summary, cont.: Kazakhstan has, to date, done an admirable job of managing its oil wealth. President Nazarbayev seems determined to take the next, rational step of lessening the country's dependence on extractive industries; the ambitions of diversifying the economy and enhancing Kazakhstan's competitiveness rank high on the Kazakhstani government's agenda. It is clearly in the USG's political and commercial interests to help Kazakhstan achieve those goals - through expanded U.S. trade, investment, and economic cooperation - while reinforcing market mechanisms. Finally, your visit here comes as the GOK grapples with a new sense of the country's regional role and responsibilities, earned by its relative prosperity and stability, and forced upon it by challenges and opportunities to the South. Here, too, the U.S. can assist, by helping Kazakhstan find the opportunities and means to increase trade and infrastructure ties with its Southern neighbors, including Afghanistan. End summary.

The Political Context

3. (SBU) Your visit comes at a time of significant personnel changes in the government, but relative stability as regards economic policy. President Nazarbayev appointed Karim Masimov as Prime Minister on January 10 (reftel). Masimov, who had been Deputy Prime Minister since January 2006 and concurrently Minister of Economy and Budget Planning since April 2006, was already the most prominent economic policymaker in the cabinet. In his first weeks on the job he has emphasized the need to diversify the Kazakhstani economy, including by attracting foreign investment, and to respect contract stability. Masimov has also highlighted the need for streamlined GOK decision-making and improved organization. Other new appointees include Foreign Minister Marat Tazhin (formerly head of the Security Council), Deputy Prime Minister Aslan Musin (who also retains his job as Minister of Economy and Budget Planning), Defense Minister

Daniyal Akhmetov (former Prime Minister and Kazakhstan's first civilian defense minister), and Minister of Industry and Trade Galym Orazbakov (who as Deputy Minister from 2001-2003 used to head Kazakhstan's WTO negotiating team).

14. (SBU) While Masimov is charting a relatively familiar economic policy course, significant changes are expected on the domestic political front. (Note: In the Kazakhstani system, the Prime Minister coordinates economic policy. Foreign policy and domestic political issues are handled by the Presidential Administration. End note.) President Nazarbayev has been consolidating the pro-presidential political parties into one grouping, Nur-Otan, which controls over 90% of parliamentary seats. He is widely expected to give a public address in February or March outlining his vision of political reform, based on the recommendations of the Democratization Commission which met throughout 2006. While no details are publicly known, participants in the Commission predict that while the rhetoric may be sweeping, the actual reform proposals will be fairly modest. One frequently-heard measure is an increase in the number of seats in the Mazhilis (lower house of parliament), which would theoretically make room for more diverse party representation.

#### The Macroeconomic Situation

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15. (SBU) Kazakhstan's economy (2006 GDP: \$68 billion) is larger than those of all the other Central Asian states combined, largely due to the country's vast natural resources and a recent history - rare in the region - of political stability. Kazakhstan also stands out among the post-Soviet Central Asian states in its record of macroeconomic reform. Financial reform has created a banking system comparable to those in Central Europe, for example, and Kazakhstan now aspires to be a regional financial center. Kazakhstan has the economic performance to match its policies, having enjoyed near double-digit growth (estimated at 10.6% in 2006) over the last six

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years, while keeping inflation in check and avoiding, to date, the "Dutch Disease" which has plagued many other extractive economies.

16. (SBU) If there a reason for macroeconomic worry, it is tied to the fact that inflation rose a full point in 2006, to 8.5%. This, combined with other signs of a potentially overheating economy - including skyrocketing rates of commercial lending; the emergence of a housing "bubble" in Almaty and Astana; and a rise in government spending, especially on salaries - has led many observers to preach fiscal restraint. Any inflation-driven appreciation of the Tenge would, of course, hurt the competitiveness of Kazakhstan's non-extractive exports, thus blunting the GOK's drive to diversify the economy. The GOK has defused these pressures to date by steering the vast majority of its oil revenues to the offshore "National Fund," which now holds over \$14 billion in assets and an improved, rule-based link to the national budget.

#### Energy: The Economic Engine

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17. (SBU) Kazakhstan's economy is dominated by the energy sector, with oil exports alone accounting for roughly a third of GDP. Kazakhstan produced 1.3 million barrels of oil per day (bpd) in 2006 -- all from onshore projects - roughly the production volume as 12005. Overall production will be boosted near year-end 2007, as Tengiz (U.S. partners: Chevron, ExxonMobil) production doubles. Kazakhstan is likely to become a top-ten oil producer soon after 2015, as offshore supergiant Kashagan (ExxonMobil, ConocoPhillips) reaches peak production and other offshore projects come on line.

18. (SBU) The GOK actually closed 2006 by revising its 2015 production estimates from 3 to 2.6 million bpd, due to delays in Kashagan field development. Your GOK interlocutors may criticize the Kashagan consortium for delays and cost overruns at that project. They may also reference an October riot at the Tengiz field, pitting Kazakhstani against Turkish workers, which delayed Tengiz production increases by several months and triggered a broad,

ongoing GOK investigation of wage discrimination against Kazakhstani employees. GOK concerns over "local content" and equity issues in the oil and gas sector have never been higher.

¶9. (SBU) While Kazakhstan possesses substantial proven gas reserves (3 billion cubic meters), it currently exports very little gas, serving principally as a transit country for Turkmen and Uzbek gas. The GOK has set ambitious targets for domestic gas production, forecasting 63 bcms by 2015. Much of this gas will be reinjected in order to maintain oil field pressure, and the GOK would like to see some gas used to create a domestic petrochemical industry (most oil majors are skeptical of the economics); remaining volumes will be available, later if not sooner, for export.

¶10. (SBU) Kazakhstan has recently begun to pursue the possibility of building one or more nuclear power plants over the next decade, capitalizing on its enormous uranium reserves (Kazakhstan is currently the world's third leader producer of uranium), an experienced corps of industry professionals, and well-developed control systems left over from its Soviet-era nuclear industry. Kazakhstan and Russia have recently signed several joint nuclear agreements - most notably to establish an international center for uranium enrichment in Russia - but there appears to be ample room for further U.S.-Kazakhstani cooperation in this field, as well as potential commercial opportunities for U.S. firms.

#### Gas and Oil Infrastructure Projects

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¶11. (SBU) All of Kazakhstan's gas exports currently flow through Russia, leaving the country hostage to GazProm politics and prices. Two projects under GOK consideration - a Trans-Caspian gas pipeline, and a gas pipeline to China - would reduce this dependence. The Kazakhstanis are currently undertaking a feasibility study of the China route, including a variation which would add Kazakhstani volumes to a pipeline originating in Turkmenistan. While the GOK seems cognizant of the risks inherent in building a pipeline which would serve a single buyer, these concerns are partially offset by Chinese avidity and the GOK's desire to gasify Southern Kazakhstan along the pipeline's projected route. If USTDA's feasibility study proves the viability of a Trans-Caspian pipeline, on the other hand, the GOK will have to confront Russian (and Iranian) opposition to the project. Your GOK interlocutors are likely to be cautious in their support of the Trans-Caspian pipeline project, reflecting their (wise) reluctance to pick a fight with Russia before the feasibility of the project is proven.

¶12. (SBU) Currently the bulk of Kazakhstani crude is exported via Russia, both through the Transneft system and the independent Caspian Pipeline Consortium (CPC) pipeline. (Small, but growing,

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volumes are shipped East to China, while negligible quantities are "swapped" South to Iran.) The majority of Kazakhstan's near-term oil production increases are projected to flow to market either through the Baku-Tblisi-Ceyhan pipeline or an expanded CPC. Long delays in the CPC negotiations have left Tengiz producers scrambling for alternative export options. (Don't be surprised if your GOK interlocutors blame one American company for the current impasse.) As a consequence, they have joined Kashagan producers in seeking the development of the Kazakhstan Caspian Transportation System (KCTS), which will join the Kazakhstani fields, by means of a new pipeline, terminals, and ships, to the BTC. The oil producers signed an initial MOU with KazMunaiGaz (Kazakhstan's national oil-and-gas company, and a partner in both the Kashagan and Tengiz projects) last week; this document defines the technical work needed to launch the project, as well as defines how the investors will create a negotiating team which will conduct eventual Host Government Agreement (HGA) negotiations with the Kazakhstani and Azeri governments.

#### On the GOK's Mind: Competitiveness and Diversification

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¶13. (SBU) Diversifying the economy away from its dependence on hydrocarbons is one of Kazakhstan's main challenges. At present,

wheat is Kazakhstan's only significant non-mineral export. GOK officials address this need, along with the more-amorphous goal of achieving the status of "one of the world's 50 most competitive countries," with regularity. To date, the GOK has focused its diversification efforts on Harvard professor Michael Porter's "cluster" concept, identifying seven sectors of presumed natural advantage for priority development: tourism, construction materials, textiles, metallurgy, food processing, oil-and-gas machinery building, and transport and logistical services. Prime Minister Masimov would be an excellent interlocutor with which to share our own vision of market-based diversification, enabled by improvements in Kazakhstan's investment climate and an expanded U.S. - Kazakhstan partnership.

#### WTO Accession

¶14. (SBU) Kazakhstan has targeted 2007 as the year of its WTO accession. WTO membership is important to Kazakhstan not only for the economic benefits it will bring, but also as a symbol of Kazakhstan's presence on the world stage. (Note: Much like two other public GOK pursuits: the OSCE chairmanship and the Winter Olympic Games.) To date, Kazakhstan has signed bilateral protocols with 16 out of the 39 members of its Working Group. In the past, Kazakhstan's WTO experts have occasionally used high-level USG visits to lobby for relaxed "WTO Plus" provisions and explain the burdens of reducing Kazakhstan's agricultural subsidies. Your conversation with the new Minister of Industry and Trade, Galym Orazbakov, will be the USG's first, and an important opportunity to understand his vision for Kazakhstani accession.

#### Regional Integration

¶15. (SBU) Kazakhstan initially greeted Secretary Rice's October 2005 call for increased regional integration in Central and South Asia with a certain degree of skepticism. As we have clarified our goals, and reassured the Kazakhstanis that we are not proposing a political "Greater Central Asia," the Kazakhstani government has shown increased enthusiasm. The reference to regional integration in the September 29 joint statement was an important milestone in this regard. The GOK has long sought to remove trade barriers with its Central Asian neighbors and to help them improve their own investment climates. Sustained USG engagement will be needed, however, to encourage a lasting GOK focus on the broader region -- not just Kazakhstan's immediate neighbors -- and to encourage the GOK to look at tougher issues such as electricity networks. (The American firm AES, Kazakhstan's leading electricity generator, is actively engaged in our efforts to increase regional electricity trades from surplus to deficit countries; to date, GOK interest has lagged.) Your interlocutors may ask what became of the USG's summer 2006 proposal to launch a Central Asia Regional Economic Integration Dialogue (CAREID).

#### The Investment Climate

¶16. (SBU) U.S. companies doing business in Kazakhstan face an investment climate that is, at times, challenging. Among their concerns are occasional GOK infringements upon contract sanctity; a growing tendency to "criminalize" civil disputes; what they view as overzealousness on the part of federal and local tax authorities, especially in the framework of ill-defined tax law; and difficulties

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in obtaining work permits for expatriate workers. Particularly since the October "Tengiz brawl" (par. 8), the GOK has intensified its scrutiny of the hiring practices of foreign businesses. These concerns, while significant and worthy of our attention, should not overshadow the fact that foreign investment in Kazakhstan is growing at a healthy rate, and that the larger, multi-national corporations, at least, tend to find strategies for managing their legal and contractual risks.

MILAS